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Tyson Foods F3Q09 (Qtr End 6/27/09) Earnings Call Transcript

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Q3: 2009-08-03 Earnings Summary

EPS of $0.33 beats by $0.11 | Revenue of $6.66B (-7.60% Y/Y) misses by $12.40M

Tyson Foods, Inc. (NYSE:TSN) F3Q09 Earnings Call August 3, 2009 9:00 AM ET

Executives

Ruth Ann Wisener - Investor Relations

Leland E. Tollett - Interim President, Interim Chief Executive Officer

Dennis Leatherby - Chief Financial Officer, Executive Vice President

Donald Smith - Senior Group Vice President - Poultry and Prepared Foods

James V. Lochner - Senior Group Vice President - Fresh Meats and Margin Optimization

Richard A. Greubel Jr. - Group Vice President, International President

Analysts

Farha Aslam - Stephens, Inc.

Timothy S. Ramey - D.A. Davidson & Co.

Kenneth B. Zaslow - BMO Capital Markets

Christina McGlone - Deutsche Bank Securities

Vincent Andrews - Morgan Stanley

Ken Goldman - JP Morgan

Robert Moskow - Credit Suisse First Boston

Heather L. Jones - BB&T Capital Markets

Akshay S. Jagdale - KeyBanc

Christine L. McCracken - Cleveland Research Company

Operator

Welcome and thank you for standing by. (Operator Instructions) Now I would like to introduce your host for today's conference, Ruth Ann Wisener. You may begin.

Ruth Ann Wisener

Good morning and thank you for joining us today for Tyson Foods' conference call for the third quarter of our 2009 fiscal year. Sorry about the delay in getting the call this morning. We had an error in our dial-in number that was published.

I want to remind everyone that some of the things we talk about today will include forward-looking statements. Those statements are based on our view of the world as we know it today, which could change. I encourage you to look at today's press release for a discussion of the risks that can affect our business.

First, we will hear opening remarks from our interim President and CEO, Leland Tollett, followed by the financial report from CFO Dennis Leatherby. Reporting on our chicken and prepared food segments will be Donny Smith, Senior Group Vice President of Poultry and Prepared Foods. Reporting on our beef and pork segments will be Jim Lochner, Senior Group Vice President of Tyson Fresh Meat.

Also joining us on the call today are Rick Greubel, Group Vice President and International President, and Jeff Webster, Group Vice President of our Renewable Products Division.

To keep the call to one hour, and to ensure everyone has an opportunity to ask a question, I ask you to limit yourself to one question and one clarifying follow-up. If you have another question, please get back in the queue. If we have any time remaining, we'll take additional questions in the order you queued up until we run out of time.

I will now turn the call over to Interim CEO, Leland Tollett.

Leland E. Tollett

Thank you, Ruth Ann and good morning, everyone. I am proud of the results that we produced for the third quarter of fiscal '09. Our operating segments are beginning to perform as they should and there is a balance across all segments of our business. The most dramatic improvement has occurred in the chicken business. That's the one that I expected and we need the most improvement in. Some of that is due to market conditions but a big piece of that is due to the efforts we've made over the past several months to get that business turned around.

We still have a lot of work to do but we've made a lot of progress in a very short period of time. In the third quarter, the beef and the pork segments continued to perform well, which they have been doing now for roughly 18 months. The prepared food segment benefited from lower input costs in addition to our improvements and execution and the changes we've made in that business model.

We continue to develop our international business. Exports in the third quarter benefited from higher volume, strong [leg] quarter prices, and strong [pork] prices. Mexico had a strong quarter due to price and product improvements. We continue to make progress in Brazil as we bring that facility up to speed, as well as progress in China. Our joint venture in India recently introduced more branded, value-added products to that market.

And our renewable products division is performing to expectations. The core rendering business is solid, the initiatives underway in fuels and pet food products, and biotech and nutriceuticals are progressing and most of the effort here is directed toward driving inedible product from our operations up the value chain.

So I'm happy that our operations improvements are being reflected in the financial performance for our company. This should be an indicator of how this company is capable of performing.

Not every segment will do well in every quarter because of seasonality but I think the range and the volatility should be diminished substantially. Our customer contracts are shorter, which keeps us closer to the market. We are current to the market with regard to grain and soybean meal.

Our team members are energized, they are excited about what they are doing. They are concentrated on continuous improvements in our operations and we are being able to execute at the marketplace without having to deal with some of the distractions we've had in the past.

With that, I will turn the call over to Dennis for the financial report.

Dennis Leatherby

Thank you, Leland. Good morning, everyone. As stated in our press release Q309, we made $0.35 per share compared to $0.03 per share in Q309. All segments were profitable and within their respective normalized operating margin ranges.

All of our operating segments performed solidly in the face of tough economic conditions and I am especially impressed with the operating performance improvements in our chicken segment, which have impacted our margins in a favorable way this quarter.

As for our other key financial measures, we had more than $1 billion in cash at the end of Q309, including $200 million in restricted cash. Total debt was $3.5 billion. More importantly, net debt was under $2.5 billion.

Like last quarter, this represents the lowest net debt balances since the IVP acquisition and is largely the result of working capital improvements. Our people have been doing a fantastic job generating and conserving cash. Our continued inventory reduction has been a big driver in these working capital improvements. A five-day reduction in inventory days represents about a $350 million improvement in working capital compared to a year ago.

Our accounts receivable improvement of 1.7 days is worth another $125 million for a combined total of $475 million compared to a year ago. Not only did this working capital reduction free up a considerable amount of cash, it also positions us well for the future and I expect this discipline will continue.

Our total debt to cap at the end of Q3 was 42.2%. On a net debt basis, it's 33.9%.

We'll continue to drive down debt as quickly as we can and are still targeting a net debt level at or below $2 billion within the next 12 to 18 months. We also have ample liquidity between unused capacity under the ABL facility and all cash, our liquidity at the end of Q309 was again about $1.7 billion.

Our cash position has allowed us to get off to a great start addressing debt. This quarter, we bought $239 million of our bonds, bringing our total purchases since March to $277 million. These bond buy-backs will result in reduced interest expense of just over $5 million for each of the next couple of quarters.

We will continue to be opportunistic in buying back our bonds, although with recent price increases, we're not buying any at the present time.

Q309 interest expense increased $37 million compared to the same quarter last year and totaled $88 million. Interest expense increased due to both our recent capital risk in Q209 and related amortization of debt issuance fees. We anticipate full-year interest expense of approximately $295 million to $300 million.

Capital expenditures for Q309 were $88 million compared to $120 million in Q308. Year-to-date spending is just under $250 million.

We expect fiscal '09 capital expenditures to be in the range of $350 million to $400 million. While less than in previous years, rest assured we are taking care of our plants and are continuing to fund good projects.

Our effective tax rate for the third quarter was 36%. We estimate for the fourth quarter our effective tax rate will be around 37%.

In closing, I would just like to thank the great leadership team with me on this call and the many team members who are delivering strong results, striving to get even better, and improving the financial health and future outlook of our company dramatically. It is a great pleasure to work with all of you and I look forward to even more improvements and success in the years ahead. It is great to see our teams come together, focused, and have fun making good money again.

With that, I would like to pass it over to Donny Smith to report on the chicken and prepared food segments.

Donald Smith

Thanks, Dennis. Good morning, everyone. In the third quarter, the chicken segment posted operating income of $143 million and an operating margin of 5.9% compared to a loss of $30 million and an operating margin of negative 1.3% in the same quarter last year. This 7.2% swing in operating margin was due to better market prices, lower grain and fuel prices, and more importantly improvements in the efficiency of our operations.

I know we've been talking about operational efficiencies for several quarters and now we can see the impact of those efforts affecting our results. We've seen improvements within our controllable areas of live operations, plant efficiencies, better yields, improved logistics costs, changes in product mix, and in shortening the length of contracts with our customers to stay closer to the market.

Inventory reduction also played a big role this quarter. The sales volume was up 5% over Q3 of '08 and a big piece of the volume came from inventory. We moved a huge amount of chicken in the past two quarters and we did it without giving up price, as indicated by the 2% gain in price per pound in the third quarter.

Because we are doing a better job running the business, we are able to capture the opportunities the market gave us and outperform the levels we discussed for Q3 in our last call. While we are pleased with what we've accomplished, we're not satisfied. We still have work to do on our operational efficiencies, growing our sales, and improving our pricing.

We are now in the fourth quarter with inventory in the best shape it's been in for years. We're doing a better job selling and being our customers' go-to supplier. We've talked a lot recently about balancing supply and demand and now that it's balanced, we plan on keeping it that way. Simply put, our plan is to sell what we produce and produce what we sell.

This quarter will be a little tougher. I am concerned about the softness in the economy. We are simply not seeing the demand recovery we had previously expected. [leg] quarter prices have fallen about $0.09 a pound in the last month or so and there's an over-supply of [bulk fresh meat] weighing on that market as well. Grain costs have come down but even though we are fairly current with our purchases, it takes several weeks for those purchases to work their way through to the finished goods inventory. In Q4, I think pricing pressure will offset much of the benefit we might get from grain, so having said all that, I think it's likely our fourth quarter return on sales for the chicken segment will be softer than what we saw in Q3.

For the longer term though, I believe our chicken segment is well-positioned. Protein supplies are forecasted to be lower. Our inventories are in much better shape and we are running a much better business.

Although there will continue to be fluctuations from quarter to quarter due to seasonality of our business, I like the position that we are in.

Now let's turn to the prepared food segment -- third quarter operating income was $40 million with an operating margin of 5.9% versus operating income of $9 million and a 1.3% operating margin in Q3 of '08, with pork being a major input for prepared foods. Of course, pork prices certainly helped us. The national launch of Right Brand Bacon is going even better than expected. We are expanding to more retail customers and growing volume every month as we support the Right Brand with radio advertising and PR campaign.

Tyson is the leading manufacturer of private label lunch meat and bacon in the retail channel. Our Mexican original tortilla business had another record-setting volume quarter. The bulk of our Mexican original sales are QSR, which has done a little better than other channels since the downturn in the economy. Our pizza crust business has been holding its own. Pizza toppings and sauces are strong. We are putting a lot of marketing support behind our Bonici brand to capitalize on the opportunities for food service pizza beyond the QSR channel.

Overall, I think the prepared food segment is running the best it has since we've owned it. Yes, we've benefited from favorable market conditions but we have a great team running this segment and we've also done a lot of work to get our footprint right, to fill up our plants and get our costs in line. We've been aggressive in our marketing efforts and we are growing the business.

As I said earlier, our team is pleased with what we've accomplished but not satisfied. We've got more work to do and what we are doing is making a difference. I am very proud of this team. They are aggressive, confident, and they are competent and I believe we are positioned in our business to compete effectively for the long run.

I want to say thank you to all our hard-working team members for all they do every day to make the difference. Now I'll turn it over to Jim for the fresh meats report.

James V. Lochner

Thanks, Donny and good morning. The beef segment made $66 million, or about 2.4% this quarter. Our Q3 is usually our strongest quarter but this year was below the Q3-Q408 results predominantly from demand pressure. As a reminder, our Q3-Q408 results were impacted by mark-to-market accounting treatment for derivatives. When those periods are combined, the operating margin for Q3-Q408 was 2.8%.

Compared to Q3 of '08, industry production volume was down with steer/heifer slaughter down over 5%, or about 31,000 head per week. However, our estimates imply domestic beef availability was only 1% to 2% less than last year because export volumes decreased and import volumes increased, offsetting the decreased production.

Weekly capacity utilization was 87%, or just over 5 days, about equal to Q308. However, our daily capacity utilization has improved dramatically over the last two years, improving our operating costs.

Capacity utilization is an important metric to watch but total revenue versus cattle cost, the gross margin spread is what determines profitability. We have improved our total revenue managing product mix, yields, and premium program sales. Additionally, we have been very careful not to over-supply the pipeline during this period of soft demand, which would drive down price.

You should keep in mind we are running a significantly different beef business than a few years ago. We closed or reorganized several regionally not competitive plants and improved staffing, which increased our daily capacity and reduced cost. This also allowed us to optimize the product mixes for revenue.

It is important to note our beef segment has averaged a 1.7% adjusted operating margin to five quarters before this one, even with a 14% decline in revenues since Q4 of ’08. Our focus on execution continues to drive results.

Looking forward in the beef segment, my view of the fundamentals hasn’t changed much since our second quarter call. We expect to see adequate supplies of fed cattle and continued demand pressure. Cattle [and feed] numbers have been lower than last year as placements have been down. This appears to be a function of fewer imported feeder cattle, excellent pasture conditions, and the implied reduction in the calf crop from prior inventory reports. Pasture conditions have been the best seen in many years. It appears cattle are likely out on pasture and will come to the feed lots later than they would have otherwise.

The fed and steer heifer slaughter reduction suggests fed supplies are being pushed into the last summer and fall. Overall, our beef team has achieved dramatic improvements from prior years and continues to focus on earnings drivers, while managing a much more competitive business.

Moving on to the pork business, the pork segment had a respectable quarter, coming in at $28 million, or 3.3% operating margin. Year over year, total revenues declined dramatically in the pork segment, close to 15%. All prices declined nearly the same as the total revenue, allowing us to manage the spread in a difficult market. The revenue pressure in the pork complex was from numerous factors, including H1N1. However, excess supplies of domestic pork from a dramatic slow-down in exports on a weak economy pressured pricing throughout the quarter. Capacity utilization for the quarter came in just over a five-day per week average, or 84%, about the same as Q308. These positive results illustrate our continued emphasis on managing a spread business and streamlining our cost structure from improved operations. Our pork team has been very focused on the day-to-day activities to manage margins, which include yields, costs, mix optimization, and pricing. We emphasize maximizing revenue and believe hog costs will follow revenue.

Hog supplies will be down in Q4 year over year but still adequate. We do expect to see liquidation accelerate and pork production decrease into 2010 and beyond to improve producer profitability. We will continue to watch forward hog supplies to drive more exports, monitor demand, focus on cost, mix, and pricing to generate revenue.

In closing, our fresh meat team has achieved very respectable results in a tough economic environment with declining revenues for prolonged periods. Our operations are functioning extremely well, our plans are fully staffed and running very efficient, even with virtually no six-day production. I am very proud of both the pork and beef groups. Their teamwork and focus on our results has been the difference in an otherwise tough economic conditions.

With that, I will turn it back over to Leland for closing comments.

Leland E. Tollett

Thanks, Jim. In closing, I want to say that I am encouraged about the direction this company is headed. We’ve had good steady improvement and performance from beef and pork for quite a while now. Our prepared foods business is doing well, and as I’ve indicated and as Donny pointed out, the chicken business is rapidly making progress.

I think people around here feel better about their work. They are seeing the results of their contribution and it shows in their attitude. It is starting to get fun around here and I don't see any reason why we cant continue in this direction.

So Operator, we're ready to take questions.

Question-and-Answer Session

Operator

(Operator Instructions) Your first question is from Farha Aslam.

Farha Aslam - Stephens, Inc.

Good morning. Jim, could we get some more color on beef? It just had a fantastic quarter. Do you expect results in the fourth quarter to be in your normalized range again, despite the difficult quarter or economic environment?

James V. Lochner

Good morning, Farha. Thank you for the comments. The fourth quarter, I do expect to stay in about the same zone that we've come through. I don't see a major shortage in livestock because the industry is not over-supply the pipeline. Demand is soft and absent any major disruption in export markets, I really don't see much change going forward.

Farha Aslam - Stephens, Inc.

Okay. And Donny, you were talking about chicken being softer going into the fourth quarter. Do you expect margins to remain within your normalized areas or do you think the market is just in for a little bit of a tough fiscal fourth quarter?

Donald Smith

I think more of the latter part there, Farha. I think it's going to be a little tougher in the fourth quarter.

Farha Aslam - Stephens, Inc.

Okay. Thank you for your comments.

Donald Smith

Thank you.

Operator

Tim Ramey, your line is open.

Timothy S. Ramey - D.A. Davidson & Co.

Good morning. Congratulations on the quarter. I sense a strong move to the risk adverse from previous quarters and years. You noted the relatively flat commodity position. We almost heard the term paper to paper, although not quite in terms of selling what you make and making what you sell. Can you talk a little bit more generally about the attitude of managing the business and how you are controlling risk in the corporation?

Dennis Leatherby

Well, as you said, we are taking less risk than we've taken in the past. I think our attitude around here until we get more stability in the commodity markets quarter on quarter and year-on-year, we will continue to do that. We will manage this business on a shorter term proposition than we've had in the past.

The idea that we can hedge everything is just -- it does not exist so therefore we are going to stay close to the market and also close to the market in terms of going to the marketplace with finished product.

Timothy S. Ramey - D.A. Davidson & Co.

Thank you.

Operator

Ken Zaslow, your line is open.

Kenneth B. Zaslow - BMO Capital Markets

You guys talked about feed costs not being -- coming down but not being realized until next year. But if I look into 2010, would you argue that the lower feed costs offset the lower chicken prices and kind of everything net net kind of comes back to where we'd be today, if we were able to just fast-forward to 2010? Or does the lower feed costs not offset the lower chicken prices?

Dennis Leatherby

The lower feed prices -- keep in mind we had a pretty good run-up in the first of June from -- the entire month of June was high. It's tailing off right now. We've got a combination of factors in place here. We've got improvements in our operations that help and they are continuing, and then we have this blurb in the price of feed there in June that takes an extended period of time to work itself all the way through. Now how that balances with the revenue side, you know, that remains to be seen a little bit. I'll turn it over to Donny and he can give that a swing also.

Donald Smith

Here's what I would say -- what we've got to do is continue to shorten up our pricing cycle, if you will. We've got our inventories in shape. If we will continue to hold our pricing in a fairly narrow window when the commodity prices on the cost side do react, we are in much better shape to recoup that cost in our pricing. So I can't tell you what the grain cost is going to be next year. We hadn't harvested the crop yet, it looks good so far but you know, lots of factors involved in that, so I don't want to get to speculating on that.

Our job is to operate our business well, keep our cost in line, and make sure that we shorten up our pricing cycles to the point that when the commodity markets do react, we're able to respond to that as quickly as we can in the marketplace.

Kenneth B. Zaslow - BMO Capital Markets

Great. Thank you. Jim, just a question on the hedges -- if I think about that, I know every quarter you write about the hedges, is that really hedging or is that basically what you do every day, you know, it just has to -- it's the accounting term of hedging because you know, you even said in your forward-looking remarks that this quarter should be similar to last quarter and I'm assuming you can't figure out what your hedges are going to be on September 30th. So is the hedging just an accounting term or is that something really -- you know, or is it just how you operate the business every day? [Because it sounds like] it's relatively flat, so I'm assuming it's how you operate, not hedging per se.

James V. Lochner

It is -- I am going to answer that by saying it is predominantly how we operate the business. We don't take any speculative positions. What happens is on occasion we'll have producers who want to sell cattle forward and we'll manage the basis risk and then if we're selling boxes forward, we're going to try to hedge our position there and so it's always a fiscal financial offset, so it is really as you said, how you really run the business but because we have to keep track of the derivatives and state them such, it implies something other than that but it is exactly what you --

Kenneth B. Zaslow - BMO Capital Markets

But so we shouldn't -- it shouldn't be considered hedging? Like the chicken side of it, the feed cost is hedging. This is day-to-day operations.

James V. Lochner

Yeah, I would say it's day-to-day operations but we use financial positions if we have to go forward on a sale or a buy.

Kenneth B. Zaslow - BMO Capital Markets

Great. I appreciate it.

Operator

Christina McGlone, your line is open.

Christina McGlone - Deutsche Bank Securities

Thank you. You talked about shortening the timeframe on the chicken contracts and I'm wondering if -- how the industry is doing with that, especially as we head into the fall negotiating season. Does the industry seem to be participating in shorter contracts in order to be able to manage commodities better?

Donald Smith

I don't really pay a lot of attention to what is going on with the other folks in the industry. I just know what we are trying to do and so far we've been successful and have been able to what I call shortening up the pricing cycle. I don't know if that's the best term for it or not but what I mean by that is to have less fixed price risk going forward certainly beyond 90 days, so I know what we are doing but that's it.

Christina McGlone - Deutsche Bank Securities

So then Donny, it's not a -- there's no risk that you would lose market share if with lower corn, competitors all of a sudden hedge out corn, go longer in their contracts -- that wouldn't be a concern to you about market share loss?

Donald Smith

I don't believe we are going to lose any market share, no.

Christina McGlone - Deutsche Bank Securities

Okay, and then I just wanted to know, in terms of the cost savings and internal efforts, I believe you have about $250 million running through your P&L and I was wondering if first if that's right and second, what's left and over what time frame it would be realized, and where you are relative to the industry in terms of efficiency?

Donald Smith

Okay. That's quite a question. Let me try to take that apart for a second. Number one, in past calls, we had discussed spending $120 million, $130 million or so and then seeing a $240 million, $250 million or so return for that. That return is in these numbers. In other words, we did -- those capital projects and those capital projects are returning like we supposed them to be, so the $250 million that you mentioned is included in the numbers that we are seeing.

In terms of what we are doing and that type of thing, we are still -- we still have opportunity in front of us. I think Leland mentioned in his remarks that we've come a long ways but we've got a lot more work to do and that's true. If I was trying to capture for you some semblance of how much of the value we've captured, I would tell you we are somewhere in the middle of the journey. Now whether that's 45% or 65% complete, I can't get near that close to it for you but I would just tell you that there's still opportunity for us in operating efficiencies. We are working on those hard every day. We've got a great team focused on those, so still opportunity to improve our chicken business.

Leland E. Tollett

We've got the relatively easy stuff done.

Christina McGlone - Deutsche Bank Securities

And where are you in terms of the industry in terms of your efficiency?

Donald Smith

You know, we have mentioned I think on a previous call, I'm hoping this gives you some kind of reference, that we were about or a little better than average in agri stats. You know, we are still in about the average area so maybe that gives you some glimpse into how we compare within the industry.

Christina McGlone - Deutsche Bank Securities

Thank you very much.

Operator

Vincent Andrews, your line is open.

Vincent Andrews - Morgan Stanley

Thank you. Good morning and congratulations on your quarter. I want to ask about production levels across the industry. One of your competitors last week announced that they are actually going to construct a new plant and that they are going to increase their level of production I think by about 7% in their fiscal year. So what are your expectations? You know, you made a comment about you are going to sell what you produce and produce what you sell, which -- how should we -- it sounds like you are saying you are not going to increase your production anytime soon, unless there's demand for it. So if you could just comment on the overall industry supply situation and how you think that will impact you on a go-forward basis.

Leland E. Tollett

About all we have to really go on is the [pull-it] placements or chicks place, chicks place being a short-term indicator of supply, pull-it placements being a longer term indicator. And both of those numbers would indicate that the supply will not be burdensome. But as far as that impacts our company, you've got it right -- we will produce according to our demand. We have no real thoughts about what the rest of the industry is going right now.

Vincent Andrews - Morgan Stanley

But you're not concerned -- you have no concern that if the rest of the industry begins to produce more, it will make it difficult for you to price -- you know, to maintain your ability to adequately price close to the market? In order words, you're not concerned about getting into a period of over-supply with still weak demand maybe six months from now?

Leland E. Tollett

I don't see that happening anytime soon. Though keep in mind if somebody started building a plant today, it would be a year, year-and-a-half before they get it up so I don't see that happening short-term.

Vincent Andrews - Morgan Stanley

Okay, and then my only other question was I've been reading the Korean export demand for beef has tailed off pretty considerably recently. Do you have any idea what's causing that and what sort of impact do you think that will have on the market, if anything?

Richard A. Greubel Jr.

I'll take a shot at that for you. Korea -- actually, exports to Korea year over year are up but you are correct that there are higher inventories in the channel for us. They are going to work their way through. Receptivity to U.S. beef at retail has been slower than we had expected and that's going to take some time to go back to those 2003 levels. The industry is about a third of the way there if that helps you think about it versus the 2003 pre-BSE peak.

But the exports overall though are really a different story, and they are up about 10% year over year. That's through May U.S.D.A. numbers and our exports would be up a little more than that so we feel pretty good about that.

Vincent Andrews - Morgan Stanley

Thank you very much. Congratulations again.

Operator

Ken Goldman, your line is open.

Ken Goldman - JP Morgan

Good morning. Gentlemen, a question on pull-its -- there's been some speculation out there among people I've spoken with that maybe the U.S.D.A., their numbers on the year-on-year declines in pull-its are overstating or understating how many pull-its are really out there.

I haven't really seen any evidence to back that up. As far as I know, the U.S.D.A. numbers are fairly accurate and I'm wondering if you can comment on that.

Leland E. Tollett

We assume that the U.S.D.A. numbers are fairly accurate. They have been in years past. We see no indicator that that's any different than that right now.

Ken Goldman - JP Morgan

Okay, and then can we get a little bit more color on what happened in the last month? I mean, I know a lot of it is seasonality but what happened in the last month to send chicken prices down more than maybe the industry expected? I know it's demand but maybe you could talk a little bit about where that demand was soft and where it sort of held in there.

Donald Smith

Okay, Ken, I'll try to take a shot at it for you. You know, I think traditionally after the Fourth of July, demand tends to soften. You mentioned the seasonality and that certainly played a part in it. I think in food service in general, we continue to see softness. I think chicken has held up fairly well compared to other proteins. We continue to focus on partnering with our customers to deliver against value propositions featuring a little heavier promotions, new value menu items, even maybe meal alternative snacks and that type of thing.

So as you switch over to the retail side, post July 4th, our demand has been fairly good on the lower value items -- drumsticks, thighs, leg quarters, et cetera. A little bit softer on the breast meat type items. You know, it seems like at the beginning of the month, pretty good demand for bonus skinless breast but here towards the latter part of the month, it was a little bit of a push.

As to why demand is down what it is, I think we continue it's part of the economic softness. I think consumers are still concerned. They are chasing value. We do see some up-tick in a couple of trends, like retail consumers tell us that they are using leftovers a little more often, you know, brown-bagging to lunch is up, those type of things which those are all things that continue to point to just general economic weakness. Food service is a little softer than retail. That's kind of the same store we've been telling. The QSR segment has held up better than full service dining -- again, that continues to be part of the story that we've been telling. So I don't think there's anything other than a bit more of the same in this economic news.

Ken Goldman - JP Morgan

Thanks very much.

Operator

Robert Moskow, your line is open.

Robert Moskow - Credit Suisse First Boston

Good morning. Donny, if it makes you feel any better, we just paid about $10 a pound for boneless skinless breast at whole foods the other day. We ate every bite of it.

Donald Smith

I appreciate that. So you're giving a testament to our leftovers or did you eat it all on the first meal?

Robert Moskow - Credit Suisse First Boston

We're putting it in a casserole soon, so --

Donald Smith

Good for you.

Robert Moskow - Credit Suisse First Boston

But I guess the comment about pork exports was interesting to me. It sounded like it fell off a lot. Recently the U.S.D.A. data doesn't give us an update to that soon. Can you tell us what the drivers of that was and do you think that there's a threat of excess red meat supplies putting pressure on chicken as well? If you look at cold storage inventories, pork is up a year ago, chicken is actually down. Could you help us with that?

James V. Lochner

Robert, let me start -- you always have to think year over year or what happened last year and you have to remember in pork exports, we're comparing against such a huge robust year in '08 and we had Russia jumped in and bought more, China bought more last year, and so year over year, we're down. Now, let's put it in relativity -- it's still not as that far off of '07.

But the key is we've got production numbers that are flowing through and compared to a year ago with those very strong exports that stimulated pricing, right now we are having that difficult because we have excess domestic supply.

And going forward, I don't see any major threats that are going to change anything, although the export arena always has its opportunities. And certainly we'd like to see more export disappearance to take less domestic supply, so the total meat pool is influenced by imports plus exports plus production.

So those would be my comments.

Richard A. Greubel Jr.

I'll add just a little bit to that, Jim. You know, there's really kind of a tale of two different stories going on in pork. Box pork exports, as you mentioned, they are down year over year, [again] through May and I think that for the industry as well as for our exports, and we are about the same level as the industry. We've made some internal choices on -- we have a large bone-in ham export market to Mexico and we saw some opportunities here in the U.S. during the quarter to run our de-boning lines and so boneless hams here in the U.S., so that was a bit of an internal trade-off, financial decision we made. But again, boxed pork is down about 8% year over year. Variety meats, however, are up significantly and we continue to see that demand continue and I think that's going to be probably the same story for the rest of the year.

Robert Moskow - Credit Suisse First Boston

Okay. And then a question for Dennis on the balance sheet -- you said that you are not going to be buying back any of your debt because the prices have gone up but you do have this $1 billion of cash sitting around. How long are you willing to wait before you do buy back your debt? And if it's a long time, what else would you do with that cash?

Dennis Leatherby

Robert, I'll have to clarify what I said -- I said we weren't buying any at the present time. We are always looking at that value equation and who knows what if and when we'd make that change but we'll continue to keep cash on the balance sheet. It's important to us to have enough liquidity. Remember, we have restricted cash set aside for the 2010s, but we also have $830 million of 2011s coming due and so our goal is to be in a very strong position to pay those off. So whether we buy them early or pay them off at their maturity, having cash on the balance sheet is important for us and certainly it helps us to the extent we need to fund capital spending and just fund our general operations.

Robert Moskow - Credit Suisse First Boston

Okay, and then regarding that, you are also lowering your CapEx guidance for the year -- are you pushing projects into next year? Or are those --

Dennis Leatherby

Not really. Not really -- we've been really efficient with our spending. I've really appreciated how the team has helped us drive cash but at the same time, there's been a lot of great projects with really high returns and I would expect next year will be another year of a lot of great projects.

Robert Moskow - Credit Suisse First Boston

Okay. Thank you.

Operator

Heather Jones, your line is open.

Heather L. Jones - BB&T Capital Markets

Good morning. Good quarter. I want to follow-up on the chicken demand question. I was wondering if -- I understand you were saying that food service is still soft. I was wondering if you've seen incremental deterioration on a year-on-year basis in any of the channels, whether casual dining or QSR? McDonald's had had some commentary, I believe it was June and July were softer than May, and so I was just wondering if you could dig deeper into food service and what are you seeing incrementally on those trends?

Donald Smith

Well, you know, I can't get to commenting QSR by QSR, but if you lumped them all together, certainly food service demand has been softer than retail. QSR has been better than full service dining. I do think though in July, we did see a bit of a discouraging relapse from the demand that we had seen in food service prior to July. Now, how long that lasts, what were the underlying consumer issues behind that, you know, it's just August the 3rd or 4th, so it's a little early for us to be able to diagnose that.

You know, Heather, we continue to position ourselves, you know, the discovery center has been very busy. We've got a lot of customers that are talking about value on the menu. We're working with them to help the grow their business and we will continue to do that. That's important for us.

You know, drilling down any further, I don't know that I would have a deeper answer for you on any specifics.

Heather L. Jones - BB&T Capital Markets

No, that's good. So basically you saw what you would characterize as a discouraging relapse in July and that didn't improve as you went through the month?

Donald Smith

No, it was softer coming out of the Fourth of July and kind of held that softness through the month. Now, what will happen going on into August and September as we get into the back-to-school mode and folks get out there and start shopping for the kids and all that kind of stuff, typically demand improves. It's not unusual for July demand to be softer than June, post Fourth of July. You know, we started from a little bit lower base, you know, with the weak economy going into this Fourth of July, so I don't know that we felt anything out of the ordinary. I think we just need to see what happens as we get into back-to-school mode here in the next week or two.

Heather L. Jones - BB&T Capital Markets

Okay. And then wondering if you could speak to what you are seeing in the export market for chicken.

Richard A. Greubel Jr.

Sure, Heather. Good morning and leg quarter market as Donny mentioned during his opening comments is definitely softer than where it was let's say a month or two ago and that's really a function of some higher inventories in most of the -- what I'll call non-Russian markets, so the Middle East, Africa, and Asia. As a result of that, we're seeing a decrease in price, a softening in price and that's probably going to be in place. Some of that is seasonal and things typically get better as we move towards the end of this quarter and the beginning of the next.

With regard to exports to pull-its to China, we have not seen any impact on our business so far in spite of all the news and the -- it was prevalent a couple of weeks ago and we still have demand. August is sold, September is selling, pricing is good. You know, that story still needs to play out. Feedback in the media from last week's strategic economic dialog, the big meeting in Washington was, in the Chinese media the feedback was very positive, so that's a good signal.

There's still more work to be done there but so far, so good.

Heather L. Jones - BB&T Capital Markets

Okay. Thank you. My final question is moving into '010 and I understand there's limited visibility but based on what you see now and assuming lower feed costs are flowing through at that point, would you think that Q1 chicken margins can get back into 5% to 7% range, or would that be a stretch?

Donald Smith

Heather, a little bit too much unknown for me to be able to call this quarter by quarter. I do think on an annual basis, our chicken business ought to be able to perform and I expect it to perform, in the normalized historical ranges but I don't -- there's no way I could speculate on a quarter by quarter basis.

Heather L. Jones - BB&T Capital Markets

Okay. Thank you very much.

Operator

Akshay Jagdale, your line is open.

Akshay S. Jagdale - KeyBanc

Good morning. A couple of questions for you guys on chicken, and maybe just a follow-up to a lot of them that have been asked -- the first one is more about sort of long-term trends and normalized margins in chicken. I mean, you talked about savings of $240 million to $250 million. That's about $0.02 a pound and on my estimate, about 3% to margins. I mean, if you are making all these operational improvements, one is how are we supposed to judge them as analysts if you are not helping us quantify them? And to that extent, why aren't you ready to raise your normalized earnings guidance if you are today a more cost-effective chicken company than you were a year ago? So that's -- if you could answer that, I have a follow-up after that.

Donald Smith

Okay, sure. On your first one, I would tell you, like I answered to Heather, on an annualized basis we ought to be able to perform in our historical ranges. Why aren't we willing to raise the range? And I don't want to -- I know I've got a lot of my team that's listening to this call and I don't want to say anything that would discourage them but it's a little too early in that we've just had one quarter in the normalized range in the last eight. So I am comfortable even continuing to talk about the previous historical normalized range and our ability to get there and we'll see what happens from there.

Akshay S. Jagdale - KeyBanc

Okay, and just in terms of your comments on the short-term outlook for chicken, from what I am reading and correct me if I am wrong, you obviously are saying it's going to be below what you reported this quarter in terms of margins for next quarter in chicken. Is that -- I mean, that's a change from what you thought in June. Is that mainly due to the demand side and your outlook for demand or are you telling us something about production that we should imply? I mean, the only thing we can see is PPC reported today as well, their volumes were down about 17%. So they are contributing about 80% of the decrease in production year-to-date.

So I'm just trying to understand whether the lower profitability in 4Q relative to what you were expecting in June is mainly driven by your expectations for demand rather than something about supply.

Donald Smith

Yes, it is due to change in expectation on demand and the market prices that I referred to in my earlier comments.

Akshay S. Jagdale - KeyBanc

Right, so if prices improve from here on, there is a possibility that those margins could come in close to 6% or even close to where you were saying before -- like, close to 7%?

Leland E. Tollett

That's probably -- that's reasonable to expect, I would think. Keep in mind the leg quarters are down, Rick, $0.08, is that about right?

Richard A. Greubel Jr.

Eight to nine cents.

Leland E. Tollett

Eight to nine cents a pound.

Akshay S. Jagdale - KeyBanc

Okay. Thank you.

Operator

Christine McCracken, your line is open.

Christine L. McCracken - Cleveland Research Company

Good morning. Just on that export situation and the weakness we've seen in like quarters, you had commented I think some of these Middle Eastern Africa Asia markets were softer. What we had heard recently was that people were concerned about the renegotiation of the Russian contract and maybe you could provide an update on what's going on there, what the likelihood is that that will get reassigned or if there will be another delay as there was last year?

Dennis Leatherby

Sure, Christina. Thank you for the question. You know, let me just step back a little bit. The softening in those other non-Russian markets is really a function of the fact that we kind of had a two-tier pricing market develop with Russia being significantly higher, call it $0.10 a pound than the non-Russian markets and that's more a function of a number of plant de-listings and the quota reduction that's occurred over the past six months relative to exports to Russia.

What it also tells you though is that there's still significant demand in Russia and we track the prices in the local market from the domestic Russian producers and those prices are still pretty strong, as well as the prices that our importers are receiving from their product in the country so there's still demand there.

On the other hand, we've managed our inventories to some of the lowest levels we've had in the past two or three years, so we're pretty confident about that. I don't think that the current pricing situation really has been affected by the concerns of renegotiating the Russian quota in what they call the sand pin regulation that occurred at the end of last year. That is going to happen. There are U.S.D.A, the Russian [Vet Service], conversations going on. We've had meetings here over the three or four months. That's going to continue. The bottom line is we fully expect that to be resolved. That doesn't mean there may not be some emotion involved between now and the end of the year but that will be resolved because the domestic production in Russia is not sufficient to meet the demand and they have to balance their concerns with food inflation and adequate supply. So that would be my take on it and we still have four or five months for that to play up.

Christine L. McCracken - Cleveland Research Company

So remind me -- that negotiation, that current agreement doesn't expire until the end of the year?

Dennis Leatherby

End of the year, correct.

Christine L. McCracken - Cleveland Research Company

And then just as a follow-up, JVS in their filing talked about expanding into case ready and value-added, which seems like a bit of -- I guess move in a different direction from what you guys have been doing the last couple of years in terms of case ready, in any case. I'm wondering, could you characterize the environment as -- is it stronger, is it -- what would be the rationale behind moving into that particular area at this point in time?

Leland E. Tollett

Good morning, Christine. The situation hasn't really changed so JVS has -- you know, they are entitled to modify their business model. I've read the bulk of their IPO and that's about all I can comment on, really. If I go much further, it would be 100% speculation and I can't get into their head, so --

Christine L. McCracken - Cleveland Research Company

Right. In terms of your case, ready business overall, have you seen any --

Leland E. Tollett

Yes, it's flowing very nicely and we continue to add a little bit more volume and other customers, so --

Christine L. McCracken - Cleveland Research Company

So if they did get into that area, then it would be quite a bit of new competition for you?

Leland E. Tollett

Well, obviously that's a simple answer of yes and -- but maybe the customer base might continue to flow towards that with a more transition of production from traditionally cut at retail to cut centrally, although this has been a long journey over a number of years an we haven't see a major growth rate in the category of case ready or cut centrally versus at retail.

Christine L. McCracken - Cleveland Research Company

All right, thanks.

Operator

Tim Ramey, your line is open.

Timothy S. Ramey - D.A. Davidson & Co.

Just a question on the comment on the private label exposure to luncheon meats. I wonder if you could shed any light on this overall sort of trade down thesis and whether you see that product to Walmart or not, whether you are part of the relaunch of their product line?

Donald Smith

Tim, I won't get into any specific customer business, although in general we are -- we do a good business in private label lunch meat, have for a while. That business has grown. I don't want to get into any customer specific issues though, but anymore general direction on your question?

Timothy S. Ramey - D.A. Davidson & Co.

Well, can you just -- I mean, this whole trade-down thesis, whether it has impacted your business in any meaningful way.

Donald Smith

You know, lunch meat demand is up just a little bit, so obviously that's helped us. In terms of the trade-down, I don't know that private label share has changed a whole lot. I could get you more detail on that if you want to follow-up with maybe some Nielsen data or something like that but I don't think share has changed dramatically, so I would tell you that we've got a good solid business, have had for a while. We've done a much better job about filling up our footprint and getting our footprint right. We've talked about our project, where we are consolidating locations and equipment into a smaller footprint, which is helping us run more efficiently. That project should be completed by the end of this quarter and that would be a positive impact on our business going forward.

Timothy S. Ramey - D.A. Davidson & Co.

Great, thanks.

Ruth Ann Wisener

Operator?

Operator

At this time, there are no more questions.

Leland E. Tollett

Well, thank you all for participating and we will talk to you the next time.

Operator

This concludes today's conference call. You may now disconnect.

Comments

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